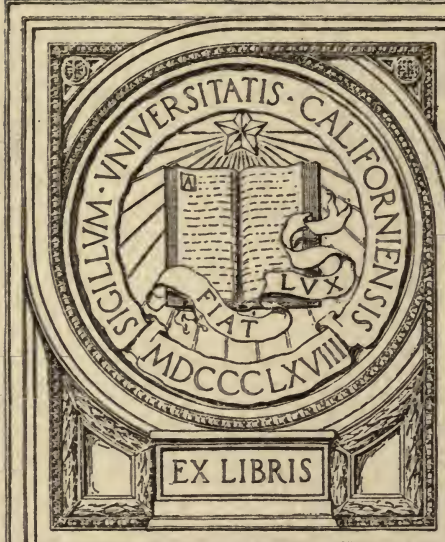
HD
2753
.U6P6

UC-NRLF
$B 91 862

810


SIGILLVM · VNIVERSITATIS · CALIFORNIENSIS
LVX
FIAT
MDCCCLXVIII
EX LIBRIS

TAXATION OF PUBLIC SERVICE CORPORATIONS

BY

CARL C. PLEHN

PROFESSOR OF FINANCE AND STATISTICS, ETC.

REPRINTED FROM THE ADDRESSES AND PROCEEDINGS OF THE NATIONAL CONFERENCE ON STATE AND LOCAL TAXATION HELD AT COLUMBUS, OHIO, NOV. 12–15, 1907

NATIONAL TAX ASSOCIATION
COLUMBUS

TAXATION OF PUBLIC SERVICE CORPORATIONS

BY

CARL C. PLEHN

PROFESSOR OF FINANCE AND STATISTICS, ETC.

REPRINTED FROM THE ADDRESSES AND PROCEEDINGS OF THE NATIONAL CONFERENCE ON STATE AND LOCAL TAXATION HELD AT COLUMBUS, OHIO, NOV. 12–15, 1907

NATIONAL TAX ASSOCIATION
COLUMBUS

HD2753
.U6P6

Digitized by the Internet Archive
in 2007 with funding from
Microsoft Corporation

http://www.archive.org/details/taxationofpublic00plehrich

UNIV. OF CALIFORNIA

TAXATION OF PUBLIC SERVICE CORPORATIONS

By Carl C. Plehn

Professor of Finance and Statistics, University of California, Berkeley, Cal.

There is a marked tendency in the United States to apply to corporations methods of taxation different from those applied to individuals. This tendency is most pronounced in those States whose economic development is most advanced. It arises mainly from the inadequacy of our old taxes to reach the tax-paying capacity of the large corporation. But it seems also to be closely related to certain recent developments in the social and economic philosophy of the times, especially to those philosophical tenets which concern the social control of the larger industrial enterprises. Government regulation of rates, the opposition to monopolistic combinations, the prohibition of discrimination, the popular condemnation of stock watering and similar abuses or manipulations of corporation capital, the demand for publicity of accounts, are all the outcome of a trend of thought which has a deal to do with shaping our tax laws.

This essay is, however, not concerned with these larger questions of social control, but will be an attempt, as if made on the part of a fiscal officer, to answer the practical question, "How can the government most easily and surely obtain from those larger industrial enterprises now for the most part conducted by corporations a fair contribution in the way of taxes?"

The legal and economic right of government to apply to corporations a method of taxation different from that applied to natural persons rests on the obvious fact that the corporation is a special creation of government, and the natural persons associating together to form the artificial person enjoy therefrom certain advantages not enjoyed by those not so specially privileged. It is clearly within the powers of the government

345848

when it creates or continues these special privileges to place upon them such limitations as it sees fit. It may consequently tax them as it sees fit. Ordinarily no fiscal officer would assume that this power to tax the special privileges enjoyed by corporation could be exercised to such an extent as to destroy the privileges. But it is certainly within the discretion of the legislative authority to exercise the power of taxation even to that extent.

The movement toward special forms of taxation for corporations in the United States is comparatively recent. If we except Pennsylvania and Massachusetts, which were the earliest to establish a clear differentiation between the taxation of corporations and that of individuals, and New York, which has been some twenty-five years evolving such a system, and if we regard the "specific" taxes of Michigan and her neighbors as sporadic or accidental exceptions, we may assert that the whole movement has taken place within the last twelve years. While it is still true that the great majority of our States to-day depend primarily on the general property tax for the taxation of corporations and individuals alike, yet of the fifty-one States and territories in the Union, fourteen, namely, Connecticut, Delaware, District of Columbia, Maine, Maryland, Massachusetts, Michigan, Minnesota, New Jersey, New York, Pennsylvania, Virginia, West Virginia and Wisconsin, have already adopted radically distinct methods for taxing corporations; of the remainder the great majority have at least started along the road already traveled by the fourteen leaders; only six, namely, Alabama, Colorado, Louisiana, Mississippi, Montana and Nebraska, can be said not to have passed the first milepost, and of these six, two are now actively inquiring the way. In short, there are but four commonwealths which have not felt the sway of the new ideas.

An analysis of the methods of taxation applied to corporations in the more advanced States shows a more or less general recognition of four different kinds of special privileges as the bases of special taxes or special methods of taxation. The first of these is the *right to become a corporation*. This is everywhere subject to fees payable at the time of incorporation which vary in amount from the mere compensation for official labor in

issuing papers to a sum which constitutes of itself a good stiff tax. The second of these is the *right to continue to be a corporation.* This is, in many of our States, now subject to the payment of an annual fee or license. This tax is among the more recent additions to our list of corporation taxes. It serves, besides its undoubted revenue-yielding function, to secure a current record of active corporations and to eliminate dead companies from the rolls. As the rates are usually graduated according to capital, it also tends to prevent overcapitalization. The third special privilege is the *right to do business in a way not granted to private individuals, or to do some particular business not ordinarily permitted to private individuals.* The States of the old South through their highly elaborated system of license taxes have developed the taxation of this special privilege more distinctly and in a more easily recognizable form than has yet been possible in the Northern States. But for special groups, like banks and insurance companies, this is a very common subject of special taxation. In some cases the taxation of this privilege has been so far extended as to cover elements akin to good will which are not taxed ordinarily when enjoyed by private individuals.

The fourth or last group of special privileges enjoyed by corporations which have been made the subject of special methods of taxation are the special franchises enjoyed almost exclusively by "public service corporations." These are privileges the enjoyment of which is never conferred except explicitly, and are distinctly in addition to the ordinary corporate privileges. In most cases they involve a partial delegation of government powers. They almost invariably result in monopoly or form the basis for monopoly, and are often extremely valuable. It is furthermore usually true of them that they have grown in value as time passed far more rapidly than was anticipated when they were granted.

There have been four different ways used in the United States for reaching this fourth class of special privileges for purposes of taxation. These are: (1) the property tax; (2) the net earnings tax; (3) the gross earnings tax; (4) the license tax. The oldest and still the most prevalent is *to treat these privileges as property* and include them in the valuation of the

taxable property. The valuation may be arrived at in two ways: (1) by valuing the tangible property and then adding an amount equal to the difference between that and the value of the stock (including bonds). This difference is called the "corporate excess" in Illinois and other States, the "value of the franchise" in California and others, or more generally the "value of the intangible property"; or (2) by ascertaining the earnings and capitalizing them, thus obtaining the value of the aggregate properties, and then proceeding as before by deducting from this aggregate the appraised value of the tangible property, thus obtaining the value of the corporate excess "of the intangible property."

The taxation of these special privileges as property is a plan which has many able advocates. The fact that two States, Michigan and Wisconsin, which had another system originally, adopted this plan after prolonged discussion and agitation has given it considerable recent prestige. But it is open to several very pronounced and serious objections. In the first place this system requires that the board, commission or officer making the valuation shall be vested with discretionary powers which cannot be characterized as other than arbitrary. These powers must be so large that if not exercised with due reserve, they may be destructive. Vesting any elective or even appointive officers with such power in regard to public service corporations has the practical effect of dragging those corporations into politics for the purpose of controlling such officers. Even if the price of reduced taxes, often amounting to many hundreds of thousands of dollars per annum, be not lure enough to tempt the corporations to struggle for the control of these boards, there is still the prod of necessity to prevent the election or appointment of a hostile board or official. Experience has shown that while it is possible for a few years, as in Michigan and Wisconsin, to establish reasonably public spirited boards of assessment, yet that after a time these boards usually become, if not subservient to the corporate interests, so inert as to be ineffective for the protection of public interests.

Directly connected with this danger is the tendency, inevitable if judged by all historical instances, for the assessment, when made on an *ad valorem* property basis, to crystallize and become

rigid. One has only to compare the growth of the assessment of railroads (the most easily available data) in those States which have used this system for any length of time with the growth in the valuations placed on other property, or, for a more telling contrast, with the growth of the gross and net income of the same railroads, to be convinced of the strength of this tendency. Any board, whether subservient to the corporations or not, after it has once made the extensive investigations necessary to fix a valuation, say, on railroad franchises, is most naturally prone to regard that as final and conclusive for some years to come. It may make additions to the assessment for improvements and for new property acquired, but it is not apt to revise its valuation of the original property. Only when such a board is sturdily enforcing some other system of taxation, under the guise of a property tax, does this tendency remain in abeyance.

That so many States still rely on the property tax for this purpose is explained: first, by the fatuous confidence of the American people in the all sufficiency of that tax in all possible contingencies (a confidence ill sustained by experience); second, by a certain confusion of thought, namely, that "equal taxation" can be attained only by applying the same form of taxation to all subjects, irrespective of differences in their character; and thirdly and lastly, by a misunderstanding of the exact scope of those constitutional provisions which safeguard interstate commerce. Of the first of these stumbling blocks it is sufficient to say that the present leaders of American political thought are unanimous in their view that the property tax is inadequate to reach all the forms of tax-paying ability which modern civilization presents. The notorious failure of this tax to reach personal property, for example, has become a favorite subject even for schoolboy debates the country over. On the second point one has only to attempt to fathom the meaning of the popular slogans used in any one of the recent tax-reform movements to be satisfied that in the popular mind "equal taxation" means merely "taxation by the same method"; as though one could justly tax a printing press, which runs 365 days of 24 hours each per annum, on the same basis, namely, that of cost of construction, as a hay press, which runs only 30 days of 12 hours each per annum.

Shallow as are in point of fact the first two of the above-named current objections to any departure from the general property tax as applied to public service corporations, the third is merely fallacious, and rests upon ignorance of the principles which guide the Supreme Court. Unless there is a deliberate attempt to limit by means of taxation the free interchange of products between the several States, the Supreme Court of the United States has never once interfered with the States as to the choice of the *form* of taxation for corporations engaged in interstate traffic. But on account of the awe in which our Constitution is held, ignorance on this point is very potent. A few years ago Canada sent a commission to this country to investigate the methods in vogue for the taxation of railroads. That commission rendered a report which for ability and obvious evidence of diligence is not easily surpassed among public documents dealing with taxation. The clear vision of these commissioners showed them the fallacy of the first two points above referred to, but so current, even among recognized authorities and among our leading attorneys with whom the Canadians conferred, was the third error that this sagacious commission carried away the impression that any method of taxation other than the property tax was unconstitutional in the United States as applied to corporations doing an interstate business. Yet in the face of this current legal view Justice Holmes, in voicing a unanimous decision of the Supreme Court of the United States, a decision in which all the wisdom of that court on this point for a century is reviewed and summarized, brushes aside a long argument with the curt statement, "We need say but a word in answer to the suggestion (he does not dignify it as an 'objection') that this tax (a tax based on gross earnings) is an unconstitutional interference with interstate commerce." The same court had previously said in regard to a tax on the property and franchises of a corporation engaged in interstate commerce, the tax being based solely on gross earnings, "that a tax of this character is within the power of the State to levy, there can be no question." (Maine *vs.* Grand Trunk Ry. Co., 142 U. S. 217.)

If we reject the property tax on the ground of its inadequacy when applied to public service corporations, we are

apparently confined to a choice between net earnings and gross earnings as a basis for taxation. Taxation according to net earnings has some very able advocates, who have built in its defense a very strong argument. If we turn away from property as a basis, it seems natural to turn first to net earnings as that which gives the property its value. When, however, any fiscal officer tries to devise a net earnings tax which will work with some degree of justice and still yield the necessary revenue, he finds himself confronted with difficulties even greater than when he tries to make a property tax effective. By long experience our law makers and our officials have acquired a somewhat definite idea of what constitutes property and of how to ascertain its value. But experience offers no such clew to what is by nature a "net" item in, say, a railroad account. The placing of any item as "net" is largely a matter of bookkeeping, and may be changed in a day by a vote of the directors or even by the instructions of an auditing officer. If taxes are to be based on net earnings, the government must not only supervise the bookkeeping, but prescribe its forms and methods, and for adequate protection it would have to dictate the character, if not the amount, of all expenses that could be deducted. That means that the cost of enforcing and collecting a net earnings tax would be well-nigh prohibitive. Furthermore, the rates would have to be so high that the temptation to enter politics for the sake of modifying those rates or the definition of "net" earnings would be greater than the public service corporations could be expected to resist. An arithmetical example will make this clear. Our railroads count, on the average, about 36 per cent of their total earnings as net. Assume for the moment that 1 per cent on the full cash value of the property is a fair tax and that 6 per cent is the rate at which we would capitalize earnings in determining the value of the property. Then for every $100 of gross earnings we should have $600 of capital and the fair tax would be $6. This is $16\frac{2}{3}$ per cent of the net earnings, a tax rate so high as to put an enormous premium on manipulation of accounts, and to hold out a glittering reward for the political control of the taxing authorities. It would seem then that the practical difficulties in the way of administering

a net earnings tax, namely, expense, uncertainty, danger of political interference, and probable evasion and inequalities, are prohibitive.

A gross earnings tax at a fixed rate for each of the different classes of public service corporations seems, therefore, the only recourse. The objection to this may be stated first: such a tax may not be absolutely equitable between the different companies within a class when measured either by property value or by net earnings. There may be a railroad, for example, whose net earnings are far above the 36 per cent average, which would apparently gain by such a tax, or, *vice versa*, one whose proportion of net earnings is low, which might, perchance, suffer. Forceful as this objection may seem when first stated, it has been found to have comparatively little weight when investigated practically. The Canadian Commission, to which reference has already been made, ascertained by a careful study of every road in Ontario that none would be really injured and none materially advantaged road against road by such a tax. The recent California Commission, after investigating in a most thorough fashion every railroad in that State which might be affected, including roads operated under conditions almost as varied as imagination can suggest, found that such a tax would be very nearly equitable for every road, with the possible exception of one. That one was a small narrow-gauge road operated in connection with a steamship and lumber company in such a way that the accounts of the three departments were so inextricably intertangled that the net earnings were not easily distinguishable so that the fact that it was an exception was a matter of grave doubt.

The economic explanation of this apparent anomaly is probably to be found in the actual outworking of the long-recognized principle that "the rate of profit on capital in all employments tends to an equality." (Mill, "Principles of Political Economy," Book II, Chapter XV, Section 4.) It is important in this connection to recall to mind that public service corporations are industrial or capitalistic *monopolies*, and that as monopolies they cannot shift a uniform gross earnings tax. Furthermore, no proportional gross earnings tax can change in any way the point of highest net returns, as it simply de-

presses the whole curve of rates by a uniform amount. In short, it is mathematically impossible for a uniform gross earnings tax to work great injustice between subjects of the same class, except in those exceptional and incompletely developed cases in which the expenses are increasing by irregular leaps as the business grows. Stated in less technical terms, the value of the public service enterprise depends on the amount of gross earnings which the manager has to conjure with, and a tax in proportion to those gross earnings can but little, if at all, disturb the relative advantages which the various companies may enjoy. The objection to gross earnings tax seems therefore to be weak.

On the other hand, the advantages of the gross earnings tax are many and obvious. The base is an easily ascertainable fact. It is not subject to bookkeeping deductions, nor can it be manipulated or falsely reported save by perjury of the most pronounced and easily detectable character. This tax requires no supervision of corporation bookkeeping, and no interference with the internal management of the corporation. The determination of the amount to be paid is a mere arithmetical computation which any newspaper, any citizen, can check up. It does not call for the vesting of administrative commissions or officers with wide discretionary powers. The tax is always in direct proportion to the fund out of which it must be paid. In short, it is safe, certain, non-evadible, inexpensive in operation, adequate, if the rate be high enough, and as equitable as, if not more equitable than, any other tax applicable to public service corporations. It will yield a revenue which will grow as the needs of government grow. It reaches, effectively, the "unearned increment" which public service corporations enjoy, without confiscating that part thereof which the original adventurers in the enterprise are entitled to under our dominant conception of the rights of private property. It fulfills the demands of a fiscal officer who wants a tax as effective, from a revenue-yielding capacity, as possible and at the same time fairly equitable. In passing it may be noted that lack of efficiency is sure to result in inequity.

It is sometimes urged as an objection that the yield of such

a tax fluctuates without reference to the needs of the government. An extensive study of this feature shows that as a matter of fact it would not fluctuate any more violently than to have the property taxes actually levied on the same classes of corporations, and that as compared with such taxes it grows far more rapidly in revenue-yielding power. It may further be urged that as any decline in the earnings of public service corporations is coincident with "hard times," it would not be unbecoming for the government then to retrench its expenses as private individuals are forced to do.

The fourth method of taxing public service corporations, namely, by special annual license taxes, has been so little developed that we have but little experience to guide us in judging its efficiency. It is used in connection with other taxes in some Southern States as a part of a general system of business licenses. The yield is never adequate, and while it may reasonably be used to fill in the lacunæ of some other tax or taxes, it cannot be easily adjusted as a sole tax. It is doubtful whether in the Northern States, which have in general surrendered the field of license taxation to the local governments, any revival of this system would be desirable.

The gross earnings tax seems to be adapted to the taxation of the following classes of public service corporations: first, all those engaged in transportation, of which we have at present the railroads, including street railroads, the car companies and the express companies; second, those engaged in furthering communication, the telegraph and telephone companies; and third, those engaged in the production, transmission and sale of light, heat and power. Incidentally it is peculiarly well suited to the taxation of insurance companies, but as these are hardly to be classed as public service corporations they fall without the scope of this essay. It is ill adapted to the taxation of water companies. This fact becomes apparent the moment one tries to determine a fair rate for a group of actual water companies. The economic reason for this is probably to be found in the fact that water companies enjoy "natural" rather than "capitalistic" monopolies. Their profits depend upon local advantages or disadvantages, and are not governed by those leveling tendencies which affect

all these industries into which capital can more readily flow when exceptional profits are revealed. The water company, whether engaged in irrigation or in domestic water supply, is closely connected with the land. The value of its plant is determined by and contributes to local land values in such an intimate way that the values of the two are both controlled by the same laws. This points to the same method of taxation for each, that is, for land and for water companies, and certainly the gross earnings tax is not applicable to land. As in the case of landowners, so in the case of water companies, the potential resources are often but partially utilized, and a gross earnings tax would not reach these unused resources as a property tax would. Moreover, the case of water companies is complicated by the numerous publicly owned plants. So far as experience is yet available, it is doubtful whether anything better than the property tax can be devised for water companies. It may as well be, however, that cities and municipal districts under irrigation would be wise to collect a fixed percentage of the gross earnings of water companies in addition to the property tax, this percentage being regarded not as a tax, but as part payment for the sale of public rights.

The determination of the rate of taxation which should be applied to the gross earnings of different classes of corporations is not so difficult as might at first thought appear. We have a fairly accurate idea of what constitutes a just tax on property. In the United States at large the average for real estate, the only class of property fully taxed, is not far from 1 per cent on the full market value of the property. For purpose of illustration we may assume that 1 per cent on property is a fair rate with which to compare taxes levied on some other basis. Should some one else decide for his own part that some other rate is fair, he can easily raise or lower the rates at which we may arrive in proportion as his "fair rate property" is higher or lower than 1 per cent. For purpose of illustration, further, our assumed 1 per cent renders the computations much simpler and the examples clearer. In each of the different classes of public service corporations there is a distinct trend towards a uniform ratio of net to gross earnings. Capital, in seeking investment, demands an average

return. If investments in any one line of public service corporations, say, telephones, yield an unusually large return, more capital enters that line, until its profits are equalized with those in other lines. So, too, if any one line yields less than the normal profit, no new capital moves in that direction until its earnings there rise to normal. The amount of capital which any enterprise can carry is determined by the net earnings. The proportion of capital to gross earnings is, therefore, what we need to know in order to determine what rate of tax on gross earnings is the equivalent of an assumed fair rate on property. This is, in turn, dependent on the ratio of net earnings to gross. It is pretty well established that the net earnings of railroads approximate on the average closely to 36 per cent of the gross, the same is true of street railroads, with a proper allowance for depreciation not often properly charged in the current accounts of such companies. In the case of express companies which require a far less proportionate amount of capital, the proportion of net to gross earnings is about 15 per cent on the average. The amount of property is relatively small, especially if one disregard intangible property. As the United States Supreme Court found in the famous Ohio Express Company cases, "$23,400 worth of horses, wagons, safes and so on, produced $275,446 in a single year." In the case of car companies, with proper allowance for depreciation, the proportion of net earnings to gross is closely approximate to that of railroads. For telephone companies the ratio is a little less than 20 per cent and for telegraph companies a little below 25 per cent. The case of light, heat and power companies presents greater difficulties on account of the rapid changes going on in the methods of production and transmission which make the rate of depreciation on the plant very rapid and very uncertain. With no allowance for depreciation they appear to earn 60 per cent net on the average, but with proper allowance for that element their net earnings appear to average something over 33⅓ per cent.

Under the system of separate sources of revenue for the State governments as distinct from the sources of revenue for local purposes, a plan which a considerable number of States have arrived at and toward which others are working, all these

public service corporations would naturally be taxed for state purposes only upon all but non-operative property. This is because they are general, not local, in character. Even the street railroads are an integral part of the general transportation system, and the light, heat and power companies which string their wires over hundreds of miles have nowadays no single mere local habitat.

The questions connected with state jurisdiction, the questions of interstate comity involved in the taxation of public service corporations, present a peculiar set of difficulties. These are, however, no greater under a gross earnings tax than under a property tax, in fact they are easier to answer under the former. It is easier to apportion the gross earnings fairly between States than to apportion the property. The property can be apportioned only on a mileage basis which gives those States with long miles of sparsely settled country through which the public service corporations operate an unfair advantage and robs those of denser population of revenue which is peculiarly their own. A gross earnings tax may be apportioned on a mileage basis as is the case with the tax on railroads in Maine, or it may be apportioned on the basis of business done as is the railroad tax of Minnesota. The latter is decidedly the more equitable between States. But if neighboring States, one densely populated and another sparsely populated, have antagonistic systems and the sparsely populated one were the one to adopt the straight mileage plan, it might work a hardship on the public service corporations. Sooner or later this must be a subject for federal regulation. The federal government must either collect all the taxes from public service corporations engaged in interstate business and apportion the proceeds among the States, or it must lay down set rules according to which alone the States may tax such corporations. Probably the latter is the more feasible plan. Meanwhile, we shall be obliged to content ourselves with such rules of interstate comity as our American sense of justice and fair play may develop. Such rules, if ever developed, will occupy, so far as concerns the States of the Union and their tax relations one to another, the same place as international law between nations. So far as public service corporations

engaged in interstate commerce are concerned the only equitable rule of "interstate law" would be, "Let each State tax all the business done entirely within its bounds, and such proportion of all interstate business as the mileage of such business in the State bears to the total mileage over which such business is done."

The writer of this essay respectfully recommends to the National Tax Association the proposal to the States of this rule as part of a code of "interstate law," and further, the indorsement of a tax on the property and franchises of public service corporations based on their gross earnings within each State as defined by the above rule, as the most equitable and expedient method for the taxation by the States of the various classes of general public service corporations.

THIS BOOK IS DUE ON THE LAST DATE STAMPED BELOW

AN INITIAL FINE OF 25 CENTS WILL BE ASSESSED FOR FAILURE TO RETURN THIS BOOK ON THE DATE DUE. THE PENALTY WILL INCREASE TO 50 CENTS ON THE FOURTH DAY AND TO $1.00 ON THE SEVENTH DAY OVERDUE.

OCT 2 1932

MAY 1 1933

FEB 23 1934

MAR 11 1935

MAY 9 1935

FEB 20 1939

APR 12 1939

APR 26 1939

17Mar'50 LP

SENT ON ILL

JUN 25 1996

U. C. BERKELEY

LD 21–50m-8,'32

UNIVERSITY OF CALIFORNIA LIBRARY